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9/04/08

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THE AUDITOR AS STANDARD-SETTER –
SOME US EVIDENCE AND ITS IMPLICATIONS

ABSTRACT

This paper provides detailed examples in a US GAAP context of what happens when promulgated rules reach preparers and auditors. We show that auditors are creating their own detailed "sub-rules" which they then impose on their clients. We suggest that such activities may be

- Outside any "due process", and therefore failing to fulfill the requirements of institutional legitimacy
- Imposing legalistic form over economic substance
- Incompatible with supposedly higher order requirements in the US GAAP hierarchy
- Inconsistent with the FASB recognition that the responsibility for selecting appropriate accounting policies rests with preparers
- Despite all the above, supported by the FASB.

We generalize the implications of these arguments in the international harmonization context and suggest that, whilst auditor and preparer application and interpretation of promulgated GAAP at the enterprise level are vital if a fair presentation of the "underlying economics" is to be given, imposed auditor rules may be incompatible with this outcome. The apparent FASB support for, or at least acquiescence in, such rules is problematic. We suggest reasons why the FASB/SEC approach might well be overturned if a case is ever brought before the US courts.

The examples of required legalistic minutiae which we discuss are incompatible with the requirements and the philosophy of International Accounting Standards, and obvious concerns arise about the promised convergence process between IASB and FASB requirements.

Keywords

institutional legitimacy; substance over form; auditor GAAP

L’Auditeur comme régulateur - Témoignages et implications aux Etats-Unis

Résumé

Cette étude fournit des exemples détaillés dans le cadre du GAAP américain de l’arrivée au niveau des préparateurs et des réviseurs de nouveaux réglements promulgués. Nous montrons que les réviseurs créent leur propre ‘sous-réglement’ détaillé qu’ils imposent a leurs clients par la suite. Nous suggérons que de telles activitées pourraient être :

- Hors de tout jugement « en bonne et due forme » et donc ne répondant pas aux exigences de la légitimité institutionnelle
- Imposant la forme légaliste sur le contenu économique
- Incompatible avec ce qui sont sensés être les exigences supérieures dans la hiérarchie du GAAP américain
- Contradictoire avec la reconnaisance du FASB que la sélection des politiques convenables de comptabilité reste la responsabilité des préparateurs.
- Soutenues par le FASB en dépit de la liste dressée ci-dessus,

Nous généralisons les implications de ces déviances dans le contexte de l’harmonisation internationale puis nous suggérons que les réglements imposés par les auditeurs sont incompatibles avec une présentation juste des « économies implicites », bien que l’application et l’interprétation du GAAP promulguées au niveau de l’entreprise par le réviseur et le préprateur soient essentiels. Le soutien apparent , ou du moins l’acceptation, du FASB pour de tels réglements est problématique. Nous proposons ici des raisons pour lesquelles l’approche du FASB/SEC pourrait être condamnée si une plainte était déposée devant un tribunal américain.
Les exemples de minutiae légaliste nécessaire que nous examinons sont incompatibles avec les exigences et la philosophie des Normes de Comptabilité Internationales, ce qui provoque des inquiétudes au sujet du processus de convergence des exigences de l’IASB et de la FASB.

Mots-clés :
Légitimité institutionnelle; contenu prévalant sur la forme ; auditeur GAAP

The Auditor as Standard-setter – some US evidence and its implications

1) Introduction

The catalyst for writing this paper was the availability to the authors of some direct and detailed evidence concerning the practical application of the rules of US GAAP. Cooper and Robson (2006), in their third section, review the state of the research literature on accounting regulation, and make a number of proposals towards a research agenda. An important element in their suggestions concerns what happens *after* the formally promulgated GAAP has been created (pp427-8):

> (M)anager and auditors have a great deal of discretion as to how rules are enacted… (T)hese observations suggest the importance of studying the *interpretation* and *implementation* of rules (emphasis added).

The detailed practical situations which we report in section 3 may be regarded as a rare insight into what may happen when promulgated GAAP reaches the real world.

We provide evidence that auditors are creating micro-rules as their own interpretation of officially issued regulations and then imposing them on their clients. We refer to this phenomenon as the creation of "auditor GAAP". We discuss reasons why auditors may rationally wish to do this, but argue that it raises major practical, conceptual, and even legal difficulties and concerns.

We embed our detailed material in the context of some of the controversial issues concerning reporting regulations, which enables us to suggest that the practical creation of de facto regulation by auditors takes place under both private and public sector regulators. Some parts of the world, often those countries with a common law system, favour a private sector body, with some form of State oversight, as the key accounting regulator. Other countries, often those with a Roman (civil) law system, favour public sector bodies but have over the last decade increasingly introduced private sector bodies that issue rules that complement the regulations codified by public sector bodies. At present the International Accounting Standards Board (IASB), a private sector body to its very core, is having its standards introduced, via an endorsement process, into the European Union (EU), this latter body being largely civil law based with a strong tradition of direct public sector (and/or courts) involvement.

The remainder of this paper is structured as follows. Section 2 provides a more general discussion on the legitimacy of financial reporting regulations issued by private standard setting bodies from a theoretical perspective. This is followed by some detailed examples from US GAAP demonstrating de facto regulations by auditors. In section 4 the practical findings are assessed in the light of the theoretical considerations presented in section 2 and implications in a European and global context are discussed. Conclusions and suggestions for further research are provided in the final section.

2) Legitimacy of financial reporting regulations issued by private institutions – theoretical considerations

As outlined in section 1 above, there are two sources of financial reporting regulation – state (public) and non-state (private). In both systems, however, the responsibility of ensuring the existence of an effective regulatory system lies completely with the state. A key issue of both theoretical and practical importance concerns the legitimacy of non-state (private) financial reporting regulation. With the advent of cross-national regulations this has become a very topical concern both at the European and at the global level.[4]

If regulation is indeed to be private sector based, the need for genuine institutional legitimacy cannot be ignored. Accounting regulations have economic consequences by imposing costs on some while benefiting others. Conflicts arise because affected parties have incompatible preferences for accounting rules (Hussein and Ketz, 1980). Standard-setting bodies attempt to regulate these conflicts by issuing accounting regulations (Hussein and Ketz, 1980). However, due to varying preferences it is

[4] Two recent papers, Wüstemann and Kierzek (2007) and Chiapello and Medjad (2007) provide evidence of very real anxieties, as also does the Radwan Report presented to the European Parliament (Radwan, 2008). We do not comment here on the (in)validity of the concerns expressed, but they are strongly held by these authors.

generally impossible to select accounting standards that achieve consent of all affected parties (Demski, 1973). Accordingly, rule-making requires ‘political’ choices making standard-setting a political process (Hussein and Ketz, 1980). Gerboth (1973: 481) therefore concludes “In a society committed to democratic legitimisation of authority, only politically responsive institutions have the right to command others to obey their rules.” Accordingly, a standard-setting body needs to possess legitimacy meaning its standard-setting authority and its standard-setting process itself are accepted by its constituencies. Johnson and Solomons (1984) provided an in depth analysis of institutional legitimacy applied to the FASB. They utilise “individualistic constitutional calculus”, which is “based on the premise that a process or institution is legitimate if it continues to be acceptable to its constituency in spite of the challenges posed to its credibility by the inevitable crises that surround the exercise of such authority” (p167). Thus the viability of a private sector regulator (such as the FASB) “depends on its ability to sustain itself against criticism of both its rule-making procedures and the rules it promulgates” (p171).

Johnson and Solomons suggest three conditions for “regulatory defensibility” (pp172-4), as follows:

> CONDITION 1 (Sufficient Authority): An accounting standard-setting process possesses sufficient authority if it has both a clear mandate of authority … and competence to carry out the assigned function.
>
> CONDITION 2 (Substantive Due Process): An accounting standard-setting process meets the substantive due process criterion if it adequately justifies each exercise of its authority and provides an adequate rationale for each ruling.
>
> CONDITION 3 (Procedural Due Process): An accounting standard-setting process meets the procedural due process criterion if it permits all interested parties a reasonable and timely opportunity to be heard and provides a reasonable opportunity to influence the rule-making process.

These conditions are held to be both necessary and sufficient.[5]

[5] Applying them (in the context of the time), Johnson and Solomons (1984: 179) conclude that: “there is support for the assertion that the FASB possesses sufficient institutional legitimacy to establish its accounting standard-setting authority and prevent its abuse.”

Condition 1 ensures that a standard-setting process enjoys an adequate level of authority necessary to carry out its intended regulatory function. This requires not only a well defined and properly limited mandate but also institutional competence assuming the body in charge has an adequate level of expertise and independence (Johnson and Solomons, 1984).

The second condition (substantive due process) is necessary to ensure the standard-setter's regulatory defensibility. It requires the decision-making body to be objective and unbiased and to act "…as a fiduciary in arbitrating disputes that may arise between the various interested parties, not as an agent of any one party or a group" (Johnson and Solomons, 1984). Acting as a fiduciary on the behalf of its constituency requires a standard-setting body to be firstly able to justify each exercise of its rule-making authority, and secondly to provide an objective (rather than arbitrary or biased) rationale for each rule promulgated. Anticipating and considering alternative points of view helps a rule-making body to defend itself against political exploitation by dissatisfied parties and reproaches that its rulings are capricious and biased (Johnson and Solomons, 1984).

The third condition, procedural due process, is based on the premise that economically affected parties should have the possibility to influence the nature and direction of rule-making. Therefore, the procedural due process condition requires that all interested parties be informed of rule making issues before a standard is issued and are given a reasonable opportunity to provide input into the standard-setting process (Johnson and Solomons, 1984)

An important issue related to the regulatory process (resulting from conditions 2 and 3 above) is the role and (un?)desirability of lobbying. This touches not only the issue that a rule-making body may be dominated by a particular party and its standards therefore biased towards the needs of a specific interest group.[6] It also links into the broader issue, which in a sense is where Johnson and Solomons started, of legitimacy

[6] This has for example been intensively discussed for the FASB, see e.g. Johnson and Messier, 1982; Hussein and Ketz, 1980. Hussein and Ketz (1991: 66) make the link explicit: "FASB due process *provides the opportunity* to lobby FASB and others to accept one's position" (emphasis added). Fogarty (1992: 346) makes essentially the same point.

and democratic control of the regulatory process. Schmidt (2002: 181), perhaps faces in both directions on the control implications. He states as follows:

> A significant aspect in the US is the threat that the FASB's rules could be rejected by the Securities and Exchange Commission (SEC). Leaving the final authoritative support for standards to a public or governmental authority can indeed serve as a considerable safeguard against special interest groups, provided, of course, that this authority clearly protects the needs of all affected individuals and is not also susceptible to such political influence.

But he then adds a footnote suggesting that "the SEC has to be judged critically in this regard" (i.e. that the SEC has indeed demonstrated an excessive susceptibility to political influence). There is ample evidence to support such criticism (see, for example, Zeff 1997, Sunder 2002: 147), but the problem surely applies just as strongly to the European Union (see the endorsement problems of IAS 39, e.g. in Alexander (2006: 70/71 with the famous letter from President Chirac as an appendix)). Cooper and Robson (2006: 428) on the other hand raise the suggestion that "non-state regulatory organizations could undermine public accountability (at least through legislative authorities)".

In the last analysis a large multinational operating in many countries will have a detailed internal manual defining very precisely the accounting policies to be followed, and the returns to be filed at head office, by each branch or subsidiary. Such manuals in practice are often as detailed as providing posting and account instructions. In this sense the issue is not "do we have detailed rules?" but "who writes the detailed rules?" Schipper (2005 :122) seems to believe that regulators will be looked to in this regard.

> If the IASB declines to provide detailed implementation guidance for IFRS, I predict that preparers and auditors will turn elsewhere, perhaps to US GAAP or perhaps to jurisdiction-specific European GAAP, for that guidance.

The spectre raised in this paper is rather different. This is that auditors will do the job themselves.

We now proceed to give some detailed examples in support of this suggestion in section 3, leading to a discussion of implications in section 4. It should be noted that it is the supposedly heavily rule-based US GAAP in which the gaps are found here, not the more principles-based IFRSs.

3) Auditor GAAP creation

We now document and discuss two recent cases of auditor influence on US GAAP.

3.1 *Auditor influence case 1*

The first example involves the application of 'cash and cash equivalents' as defined in SFAS 95. According to SFAS 95, cash equivalents are

> short-term, highly liquid investments that are … readily convertible to known amounts of cash [and are] so near their maturity that they present insignificant risk of changes in value because of changes in interest rates, … generally only investments with original maturities [to the entity holding the investment] of three months or less qualify under that definition.

Two very common instruments used in the US for investing cash on a short-term basis are Auction Rate Securities (ARSs) and Variable Return Demand Notes (VRDNs).

ARSs are securities with a stated or contractual maturity generally of some 20 or 30 years. After their initial issuance, the interest rate on the securities is reset at periodic intervals, which intervals are established at the time of the initial issue. These intervals are short, typical examples being 7, 28 or 35 days. At each reset time, the existing holders of ARSs have three alternatives, namely to continue their existing holding and accept the new interest rate (which is set by a market bidding process), to join in the bidding process by proposing a new rate, necessarily liquidating the securities if their rate bid is not accepted, or, thirdly, to sell. If an auction fails, e.g. because sell orders are greater than buy orders, then an existing holder has to retain his holding until the next auction date. Investors cannot force issuers to redeem ARSs if an auction fails. However, unless there is a credit crisis by the issuer, or possibly the issuer's insurer, auctions do not in practice fail.

> Despite the long-term maturities, from an investor's perspective, ARSs are priced and subsequently trade as short-term investments because of the interest rate reset feature
>
> (PWC, 2005, para 2; 2006 para 5).

VRDNs are broadly similar in their effect. They again have a stated or contractual maturity term of, typically, 20 to 30 years. But after the initial issue, a VRDN's interest rate periodically resets, at intervals predetermined at the issue date, eg daily, weekly, monthly etc. by a predetermined mechanism. Generally, the VRDN agreement allows the investor to tender the note for repurchase at the same intervals as for the interest rate resets, i.e. there is a built-in put facility in the contract (unlike with ARSs). Only a minority of VRDNS can be tendered to the issuer of the VRDN, while most VRDNs can only be tendered to an agent, i.e. an entity other than the issuer.

It can be seen that ARSs and VRDNs share two key characteristics. These are firstly that the instrument as issued has a long maturity date, and secondly that they are *de facto* operated regularly and reliably as short-term highly liquid investments. The question is; are they cash equivalents under US GAAP? For many years, US companies classified both as cash equivalents, due to the possibility to exit the instruments whenever required within a period well under three months, with the full agreement of auditors and regulators. SAP provides one example of this.

Even at this stage, it is clear that a significant issue is the relative importance of the technical legal position on the one hand versus the practicalities of the market place on the other. The *de jure* (form) position is that an ARS auction could fail, potentially leading to relevance of the nominal term of the security, which is longer than three months. The *de facto* (substance) position is that there is a reasonable and reliable expectation of the availability of non-loss-making liquidation within significantly less than three months. The general principle of substance over form in US GAAP[7] therefore supports the longstanding acceptance of cash equivalence.

[7] See for example AICPA (2001): "Generally accepted accounting principles recognise the importance of reporting transactions and events in accordance with their substance. The auditor should consider whether the substance of transactions or events differs materially from their form".

In February 2005 PWC issued guidance (PWC, 2005) that ARSs should not be treated as cash equivalents, following the *de jure* argument above. Under the subheading "PWC Observation", the document states as follows.

> To properly classify its auction rate securities, an investor must determine, at the time of purchase, when the securities will mature. Given that most auction rate securities have maturities that span many years, such securities will qualify as cash equivalents only if they are acquired three months prior to maturity.
>
> We understand that the other three major accounting firms all presently hold a similar view, although some have only recently come to their current position. Through discussions with these other firms, we also understand that this view is shared by the staff at the FASB, Securities and Exchange Commission (SEC), and the Public Company Accounting Oversight Board.

This last comment is somewhat misleading. While there is no evidence of the views of the FASB staff, the minutes of an FASB meeting in 2005 (FASB, 2005) show that the FASB discussed whether it should provide authoritative guidance on whether ARSs (and VRDNs) are cash equivalents. They also show that different FASB board members had different opinions, and the FASB decided not to work on the issue. The discussions with the SEC that PWC mentions showed obvious effect. In March 2005 the SEC staff added to its website guidance in line with the PWC position (http://www.sec.gov/divisions/corpfin/acctdis030405.htm). It remains open whether the insight into the views of the SEC staff and the PCAOB result from comments that clients of the major accounting firms have received from the SEC as part of the SEC's regular review procedures, or that the accounting firms themselves have received from the PCAOB as part of PCAOB reviews of the firms' working papers.

At the time, VRDNs were said to be unaffected by the new arguments, as they included an unavoidable put option, giving an obligation of the issuer or its agent to buy, thus ensuring that the investor can liquidate. However a year later PWC issued new guidance (PWC, 2006) which said that most VRDNs should *not* be classified as cash equivalents.

The argument, applicable now to both ARSs and VRDNs, is (PWC, 2006 para 10) that for cash equivalent classification,

> Either (1) the security's maturity date must generally be no later than three months after the date of purchase, or (2) at all times throughout its term, the security must be allowed to be put to the issuer within three months….

The key point is the "to the issuer". Whilst the typical VRDN contract guarantees liquidity to the investor, it does not guarantee it *from the issuer*. It follows that the letter of the SFAS 95 cash equivalent definition is not generally satisfied. A PWC observation adds:

> The apparent financial strength of the financial institution providing a line of credit or any other credit-enhancer, coupled with well-defined and prompt contractual access to such credit, is *not* a factor suggesting cash equivalency. Ultimate access to the issuer is required. The probability that the issuer will be required to redeem the security is not relevant; what is relevant is whether the issuer stands ready to redeem within three months if called upon.

The 2006 PWC document, like the 2005 one, claims support and agreement from "the other three major accounting firms and the SEC staff", although the SEC staff has until today not added the VRDNs to the guidance on ARS quoted above – despite several updates of the document (see http://www.sec.gov/divisons/corpfin/cfacctdisclosureissues.pdf). This argument is of course a classic and pure example of form over substance, in direct opposition to the conceptual principle that the economic substance of a transaction or situation needs to be presented, whatever the legal form might be. The principle of substance over form is a paramount concept under US GAAP. Though it is not explicitly stated as a qualitative characteristic of financial information, it is inherent in the qualitative characteristic of representation faithfulness.

> The quality of reliability and, in particular, of representational faithfulness leaves no room for accounting representations that subordinate substance to form. (FASB 1980, SFAC 2, Appendix B, para. 160).

The Financial Accounting Standards Advisory Council therefore concludes:

> to be representationally faithful, accounting measures or descriptions must reflect economic phenomena—economic resources and obligations and the transactions that change them—and not simply accounting notions. (Financial Accounting Standards Advisory Council, 2005, p. 5).

The substance over form issue has been thrown into greater prominence in the US context by the Enron events. Baker and Hayes (2004) make a number of interesting comments. They suggest that historically, substance over form has been less dominant under US GAAP than under IFRS (pp769-70), and that an increase in emphasis on substance would certainly be beneficial, though not a simple panacea, in the US. Most tellingly from the viewpoint of our arguments in this paper, they make an explicit allegation against the FASB (p783):

> In effect, the FASB has allowed SPEs to be created *knowing that they represent form over substance* (emphasis added).

Exactly the same thing seems to be happening here, with the FASB working by proxi through the Big Four. Certainly the effect of the pronouncements we describe is that many companies have been forced, *by their auditors*, to change their accounting policies, with retrospective restatement if material, twice in two years. A full text search of the term "reclassification of auction rate securities" in the SEC's database of companies' annual reports on Form 10K filings (including amended filings (10-K/A)) reveals a list of nearly 50 companies. Some of these companies even reported a weakness in their internal controls over financial reporting in connection with the restatement/reclassification.

An illustration of preparer reaction is given by a press release of 19 July 2006 put out by the Association of Financial Professionals (2006).[8]

Quoting the President and CEO of the AFP, the press release states as follows:

> As FAS-95 is currently written, it is not responsive to today's markets and fails to recognise today's investment infrastructure. Twice in the past two years companies were forced to abandon accepted practices when the 'Big Four' firms made immediate, unilateral and retroactive changes applying

[8] The AFP is a global organization that serves more than 14.000 corporate treasury and financial management professionals. It provides professional certification, education, training and career development, research, promulgation of industry standards, financial tools and publication, and representation to legislators and regulators. The mission of AFP's public policy program is to bring the profession's point of view to the attention of legislators and regulators. In this function the AFP is also concerned with accounting issues. Via press releases and comment letters the AFP factors the concerns of its members into public discussion and to the attention of the FASB (Association for Financial Professionals, 2007). It is, in short, a lobby body.

> narrow logic to the cash definition. The standards are no longer being applied universally and CFOs and corporate treasurers are now questioning if money market accounts can still be considered a cash equivalent or whether these accounts will be the next target. The time has come for FASB to update FAS-95 to assist practitioners in better understanding the definition of cash equivalents.

The last sentence of this quotation is a not very subtly worded request for FASB to overrule the accounting firms.[9] The first sentence, assuming it is correct, would be a proper justification for so doing.

It is clear that two types of issue arise from the situation we describe. The first concerns the validity of the arguments themselves. This reduces itself in essence to consideration of substance over form, principles versus rules, and the extent to which financial statements and reports are, or are not, supposed to reflect the "underlying *economic* reality" (Levitt, 2003, emphasis added). We discuss these issues and their implications in section 4.

The second issue concerns the regulatory, governance and due process aspects. It is this latter consideration which is a fundamental concern of this paper. Before discussing this in detail, we present our second example of auditor influence on US GAAP.

3.2 *Auditor influence case 2*

This example concerns Software Revenue Recognition, specified in SOP 97-2 as amended by SOP 98-9.

The topic of revenue recognition in the software industry belongs to the areas for which US GAAP provides a high level of authoritative guidance. Since the issuance of the AICPA's Statement of Position 97-2 "Software Revenue Recognition" (SOP 97-2), which includes 145 paragraphs, three appendices and a glossary, a substantial amount of further guidance has been issued, including nearly 40 Technical Practice

[9] The AFP sent a comment letter, along the lines of the press release, to the FASB.

Aids (TPAs) issued by the AICPA, several EITF issues[10] and the SEC's Staff Accounting Bulleting 104 (SAB 104). Furthermore SOP 97-2 makes reference to other authoritative guidance.[11] Despite this broad coverage all four Big Four have issued books on software revenue recognition. (KPMG, 2007; Ernst & Young, 2007a; PricewaterhouseCoopers, 2005, Deloitte & Touche 2006) While all four books state their main purpose to be helping the understanding and application of the existing guidance, all four books go beyond this purpose by adding their interpretations of issues or details of issues which are not specifically covered by the authoritative guidance.[12] By that the audit firms add additional guidance to the existing authoritative guidance. While this guidance is not authoritative by nature it can be assumed and experienced in practice that the audit firms expect their clients to follow this additional guidance.

In the following we provide an illustration to outline how far this additional guidance goes, how the guidance differs from audit firm to audit firm and how it adds a layer of detail which makes the portfolio software revenue recognition guidance in its entirety even more rule-based than already provided by the authoritative guidance alone.

Illustration:

It is common practice in the software industry to sell to customers post contract support services (PCS), under which the software vendor provides maintenance services (telephone support etc.) and/or unspecified upgrades and enhancements for software previously sold to the respective customers. If such PCS is sold together with the respective software, a multi element arrangement exists and the question arises how the total fee from the arrangement is to be allocated to the software and the maintenance (and possibly other services sold with the software and the PCS). For this allocation purpose SOP 97-2 introduced the concept of *vendor-specific objective*

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[10] There are EITFs that specifically deal with the scope of SOP 97-2 (EITF 00-03 "Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware"; EITF 03-5 "Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software". Other EITFs are not specific to the software industry but nevertheless impact software revenue recognition (e.g. EITF 01-9 "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products")

[11] E.g. SFAS 48 "Revenue Recognition When Right of Return Exists"; SOP 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts"

[12] The extent of providing additional guidance is less profound in the PWC book than in the KPMG book and the E&Y book.

evidence of fair value (VSOE) as the authors of SOP 97-2 believed that product offerings by different software vendors are too different to allow the use of a non-vendor specific fair value concept.[13] Paragraph 10 of SOP 97-2 provides that

> If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value.

Paragraph 10 also provides that VSOE of an element is usually:

> the price charged when the same element is sold separately.

Paragraph 57 of SOP 97-2 provides specific guidance for PCS which is very similar to the general guidance in paragraph 10:

> If a multiple-element software arrangement includes explicit or implicit rights to PCS, the total fees from the arrangement should be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraph 10. The fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate).[14]

While paragraph 58 of SOP 97-2 provides guidance on how to account for PCS if sufficient VSOE does not exist for PCS, neither SOP97-2 nor the related TPAs and EITFs provide guidance on how to determine whether sufficient VSOE exists or not. While the PWC book and the Deloitte & Touche book are mostly silent on the issue, both the E&Y book and the KPMG book fill this gap by providing detailed guidance on the process to determine whether VSOE exists. Both books identify and describe in detail two approaches for VSOE determination:

[13] "AcSEC considered allowing the use of surrogate prices such as competitor prices for similar products or industry averages to determine fair value. However, AcSEC believes that inherent differences exist between elements offered by different vendors. These inherent differences led AcSEC to conclude that only vendor-specific evidence of fair value can be considered sufficiently objective to allow the allocation of the revenue to the various elements of the arrangement." (SOP 97-2.100)

[14] It should be noted that "vendor-specific fair value" is a theoretical oxymoron under both IASB and FASB GAAP. "Vendor-specific" is obviously an entity-specific concept, and it is precisely this element which leads to the postulated "objectivity". Fair value is a market-based, non-entity-specific concept, as (e.g.) SFAS 157 confirms. The fact that SOP 97-2, despite its inconsistency with FASB definitions *and standards*, is being rigorously enforced, raises important issues about the real-world operational inter-relationships within the US GAAP hierarchy. Since SFAS 157 explicitly excludes VSOE from its scope, the FASB is presumably aware of the tensions. Para 16 of EITF 00-21 views VSOE as the preferable evidence of fair value. We comment further in section 4.

- the Bell-Shaped Curve Approach: the Bell-Shaped Curve Approach requires to analyze a software vendor's entire population of PCS renewals, i.e. the rates the customers pay for PCS after the initial PCS term is over. VSOE for PCS exists if a clear majority of the renewal rates are within a narrow range of pricing.

- the Substantive Renewal Rate Approach: the Substantive Renewal Rate Approach looks at the renewal rates stated in the contract and concludes that VSOE exists if the contractual renewal rate is substantive.

Both books go further by explicitly stating that they regard these two approaches as the only acceptable approaches.[15] The E&Y book (page 290) additionally states a clear preference for one of the two approaches:

> Further, we believe that use of the Bell-Shaped Curve Approach is preferable to the Substantive Renewal Rate Approach, as it is more consistent with our understanding of the concepts underlying VSOE of fair value. Accordingly, we would not support as preferable a change from the Bell-Shaped Curve Approach to the Substantive Renewal Rate Approach.

The importance of the last sentence of this quote becomes clear if one considers that publicly listed US companies under SEC rules are only allowed to make an accounting policy change if the auditor issues a statement that this change is preferable.

Both books furthermore specify the key requirements of the approaches but are not fully consistent in this specification. E.g.:

- With regard to the Bell Shaped Curve Approach requirement to have the majority of the price points within a narrow range, the E&Y book (page 290) states that this criterion is met if 80% of a software vendor's PCS renewal transactions fall within a range of plus or minus 15% from the midpoint of the range. The KPMG book (page 165) states the same 15% width of the range but believes that it is sufficient if the number of contracts within the range

[15] KPMG (page 165): "We believe there are two acceptable methods for determining VSOE of fair value for PCS"; E&Y (page 289): "We believe that two approaches to establish VSOE of fair value of PCS exist"

"approaches 80%.[16] The Deloitte & Touche book states (page 24): "For example, if 90 percent of a vendor's separate sales of PCS during the past 12 months were priced between 15 percent and 17 percent of the net license fee, it may be appropriate to conclude that such separate sales prices constitute evidence of fair value". In a statement not specific to PCS, the PWC book provides a different threshold: "In most instances, VSOE of fair value will be an average price of several recent, actual transactions that are priced within a reasonable range (in general, variances should typically be 10% or less)."

- With regard to the Substantive Renewal Rate Approach requirement that the renewal rate must be substantive, the E&Y book states (page 292):"We generally would be skeptical that a PCS renewal rate less than 10% of an intial software license fee is substantive." The KPMG book does not provide such a threshold.

The following example explains the impact of the audit firms' guidance and the differences among them: Imagine a vendor sells to a customer software for € 1 mill. and one year of related PCS for € 0.14 mill. To identify the appropriate accounting the software vendor performs a test to determine whether VSOE of fair value exists for the PCS. Based on an analysis of the transactions of the previous period the vendor determines that 78% of the vendor's prior period PCS renewal transactions fall within a range of plus or minus 15% around a median price of '14% of the software fee'. 82% of the transactions fall within a range of plus or minus 17% around a median price and 39% of all transactions fall within a range of plus or minus 10%.

- If the software vendor's auditor is Ernst & Young, the auditor would likely based on its audit firm guidance take the position that VSOE of fair value for PCS does not exist as the 80% threshold for a +/- 15% range is not met. Such non-existence of VSOE would under SOP 97-2 result in recognizing the entire € 1.14 mill. arrangement fee ratably over the one year PCS term (assuming all other SOP 97-2 criteria for revenue recognition are met).

[16] This is the wording introduced in the second edition of the KPMG book. Interestingly the first edition of the KPMG book asked for a 80% threshold, not the 'approaching 80%' threshold.

- If the software vendor's auditor is KPMG, the auditor would likely based on its audit firm guidance take the position that VSOE of fair value for PCS exists as the result of the test (i.e. 78%) meets the criterion of 'approaching 80%' for a +/- 17% range. Such existence of VSOE would under SOP 97-2 result in recognizing the € 1 mill. fee for the software license up front upon delivery of the software and the € 0.14 mill. PCS fee ratably over the one year PCS term.

- If the software vendor's auditor is Deloitte & Touche, the auditor would likely based on its audit firm guidance take the position that VSOE of fair value for PCS does not exist as the 90% threshold for a +/- 17% range is not met. Such non-existence of VSOE would under SOP 97-2 result in recognizing the entire € 1.14 mill. arrangement fee ratably over the one year PCS term (assuming all other SOP 97-2 criteria for revenue recognition are met).

- If the software vendor's auditor is PWC, the auditor would likely based on its audit firm guidance take the position that VSOE of fair value for PCS does not exist as only a minority of the prior period arrangements fall within a plus or minus 10% range. Such non-existence of VSOE would under SOP 97-2 result in recognizing the entire € 1.14 mill. arrangement fee ratably over the one year PCS term (assuming all other SOP 97-2 criteria for revenue recognition are met).[17]

Interestingly, an article in the CFO Magazine (Stuart, 2008) quotes a SEC staff members as follows:

> "We know that some of the firms quote that 80 percent within 15 percent rule, but we try not to treat that as a bright line. The goal is to demonstrate consistent pricing practices".

[17] SAP recently acquired a new subsidiary, previously an Ernst & Young client. The process of changing its accounting policies to those of the SAP group (audited by KPMG) demonstrate a significant correlation between company/group accounting policy, and the manual contents of the corresponding audit firm.

3.3 *The rationality of auditor GAAP*

There are a number of different types of activity which could be construed as causing GAAP to be created by auditors. The simplest is probably when the auditor is asked to confirm the validity of a company's proposed accounting policy, or when the auditor is asked to advise a single client on the appropriate treatment of a particular situation. A rather more formalised situation exists when audit firms issue their own guidance on general or specific topics in "book" form. Some of these are focused, and obviously branded, such as the revenue recognition material we discuss in section 3.2. However others have a more gentle association with an audit firm, and the branding by that firm is played down in the marketing process. For example the book "Rechnungslegung nach Internationalen Standards" (Adler, Düring and Schmaltz, 2006) providing guidance to IFRS is associated with KPMG and PWC, but is not marketed in this way. "International GAAP" (Ernst & Young, 2006) is "authored" by Ernst and Young , but published by LexisNexis, and the Memento Pratique Francis Lefebvre in France is sponsored by PWC (e.g. PriceWaterhouseCoopers, 2004).

There is a long history of professional bodies, representing auditors and accountants collectively, being associated with the creation or development of GAAP. In the UK the Institute of Chartered Accountants in England and Wales issued a series of "recommendations" beginning in 1942, and the six UK Professional Accounting Bodies were closely involved with the Accounting Standards Committee (whose pronouncements were "intended to be mandatory" on their members (but only by the rules of membership, not by statute)) from 1970 to 1990. The US standard setters before the FASB's creation in 1973 were bodies within the AICPA. In a formal sense, auditor influence on standard-setting has declined as standard setters have become more broadly based. It is perhaps not too fanciful to suggest that auditors have simply carried on, now as individual firms, trying to influence and advise.

A number of motivations can be suggested to explain the desire of audit firms to carry out these activities. Part of the story is surely marketing and image-building. Topics and foci may be chosen to increase auditor exposure in chosen industries or regions, rather than to maximise usefulness to the development of financial reporting. But of course there are more genuine theoretical reasons. Accounting rules affect the auditor's attestation function, especially the auditor's legal exposure (Johnson and

Messier, 1982). Auditors therefore may have a preference for clear and detailed reporting rules that reduce their legal exposure. From this perspective it is not good for "an audit firm" to be seen to apply different criteria, and approve different solutions, in situations of apparently similar "underlying economics", so a mechanism for achieving internal consistency across an audit firm is rationalised.

A further possible explanation is that client companies tend to talk between themselves, and if they have the same auditor such conversations often are around comparisons of the positions the auditor takes in the different companies. After such talks companies will go to the auditor and complain about the scenarios in which they believe they were treated worse than other clients of the same auditor. To avoid such games the auditor needs detailed rules to be applied consistently to all clients (Sunder, 2002: 148).

Taking a more detached view, it can be suggested that auditor GAAP creation by audit firms should lead to greater consistency within that audit firm (but not necessarily between audit firms), and that auditor GAAP creation by professional bodies should lead to greater consistency both within and between audit firms. A further likely outcome however is a tendency to an increasingly rule-based approach, the more so as the auditor GAAP now comes in "underneath" the more formal regulations. The examples we give above surely illustrate the development of a rule-based approach to the level of considerable minutiae. This may best serve auditor needs but not necessarily be compatible with the preferences of other affected parties.

3.4 Auditor GAAP and the US GAAP heirarchy

The "factual" conclusions from the situations we describe in sections 3.1 and 3.2 may be summarised as follows:

- even in the rules based US GAAP system there are gaps leaving room for interpretations
- auditors seek to fill those gaps consistently across their clients by creating, and imposing, their own interpretations
- such interpretations may not be consistent between audit firms.

The two detailed illustrations we give have some contrasting characteristics. In particular, section 3.1 provides an example where the auditors have made a material, indeed highly significant, change in existing practice. The situation in section 3.2 however is more an illustration of the auditors defining existing requirements more precisely, i.e. determining practice, using bright lines, rather than changing it.

It is worth noting that the GAAP hierarchy specified in SAS 69 (AICPA, 1992) is important here. This describes four categories of accounting sources:, *(a)*, *(b)*, *(c)*, and *(d)* together with other types of accounting literature *below level (d).* FASB Concepts Statements fall in this last very low level category (a very different situation from that relating to International Accounting Standards, where the conceptual framework, whilst subsidiary to actual Standards and IASB Interpretations, assumes major significance in the preparation of Standards, the interpretation of Standards and in determining actual practice regarding transactions for which there are no Standards).

This GAAP hierarchy is in the process of revision, and a “near-final” new version is available (FASB, 2006). This is summarised in Table 1.

[Table 1 about here]

Although the FASB does not expect the new GAAP hierarchy to change current practice, three points are of real practical significance when comparing the proposed new GAAP hierarchy with the existing one. The first is that the GAAP hierarchy has been moved from the Statement on Auditing Standards No. 69 (SAS 69) (AICPA, 1992), which was directed to the auditor, to a SFAS. The reason for doing this is that

> (t)he Board believes that the GAAP hierarchy should be directed to enterprises because it is the enterprise (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP (FASB, 2006: ii).

Second, the FASB has expanded category *(a)* accounting principles to include all accounting sources that were subject to its due process. Thus, category *(a)* accounting principles are characterized by being deliberated by the Board or its designee in a public forum, exposed to the public for comment, and approved by the Board before being issued. “FASB staff positions” which were not addressed in SAS 69 have therefore been included in level *(a)* pronouncements. Third, the low and largely dismissive position of “FASB Concepts Statements” has *not* been altered, ostensibly as the FASB intends to address this issue in its conceptual framework project (FASB, 2006).

It is important to relate the various documents which we discuss in this section to the GAAP hierarchy, for two reasons. The first is the practical consideration that if a higher level document tells you clearly what to do, then there is no need to investigate a lower level document, so knowledge of which level a document falls in is clearly essential. Without substantial alterations to AICPA’s SAS 69.07 as included in Audit Section 411, the near-final SFAS XXX.4 (FASB 2006), states.

> If the accounting treatment of a transaction or event is not specified by a pronouncement in category *(a)*, an enterprise shall consider whether the accounting treatment is specified by an accounting principle from a source in another category. In such cases, if categories *(b)*-*(d)* contain accounting principles that specify accounting treatments for a transaction or event, then the enterprise shall follow the accounting treatment specified by the accounting principle from the source in the highest category—for example, follow category *(b)* treatment over category *(c)* (FASB, 2006:2).

The second reason why determination of the relationship between the specific documents referred to and the GAAP hierarchy(ies) is important in that it opens up the research question of whether or not the promulgated hierarchy is being followed in practice. We have already hinted in footnote 14 that this may not be the case, and further consideration follows in section 4.

However, comparison of the various types of documents from section 3 to the two hierarchies is a rather difficult exercise, which, given its practical significance, is a point worth noting in itself. Broadly, SOPs are category *(b)*, EITFs are category *(c)*, and all other documents and inputs are either category *(d)*, or below. (Audit) handbooks are explicitly included in the GAAP hierarchy below category (d). But since audit handbooks have in practice a strong influence on widely recognized accounting practice they can de facto be moved up to category *(d)* accounting sources. The suitability of accounting literature below category *(d)* has to be judged according to its relevance, the specificity of the guidance, and the authority of the issuer or author (FASB, 2006). It is these low level detailed statements which seem to have most practical influence, even if, as we discuss in more detail below, they are inconsistent with higher level pronouncements.

4) Regulatory considerations

In this section we discuss a range of issues arising from the "evidence" which we present in section 3. Much of the discussion is in the explicit context of US GAAP, but we conclude with a consideration of implications in the European and global context.

4.1 *Institutional legitimacy*

The first question is whether or not the examples given in section 3 are consistent with the three necessary and sufficient conditions for institutional legitimacy proposed by Johnson and Solomons. In other words, to the extent that the propositions we discuss are a *requirement* for listed companies reporting under US GAAP, is the controlling body, i.e. FASB, doing its job properly? The issue here is that the FASB, on the one hand, which has according to Johnson and Solomons (1984) got institutional legitimacy, has not specified these requirements at all. The audit profession, on the other hand lacks legitimacy as a rule-making body.

First, the mandate to issue accounting interpretations necessary for meeting condition 1 (of section 2) for institutional legitimacy is questionable. The audit profession has not got a clear mandate to issue accounting rules. However, (audit) handbooks are explicitly included in the GAAP hierarchy below category (d) giving the audit profession some rule-making authority by the AICPA/FASB. Audit handbooks in turn have in practice a strong influence on widely recognized accounting practice moving them de facto up to category *(d)* accounting sources. Thus, although the auditing profession does not have an explicit and clear mandate to issue accounting interpretations (neither from the FASB nor the AICPA) it has nevertheless got some de facto authority as a rule-making body via its promulgations included in the GAAP hierarchy.

Second, conditions 2 and 3 relating to substantive and procedural due process are also both unsatisfied. The audit profession neither provides any justification when exercising its de facto rule-making power, nor any rationale for the rules it promulgates, impairing the objectivity of its decision-making process. Finally, there is no due process of any kind giving interested parties the opportunity to express their views. Incidentally, there is also absolutely no evidence that the audit firms are attempting their own due process by engaging in open dialogue with other parties such as preparers or users. It appears that audit firms send drafts of their books to SEC staff to get comment and feedback, but this is not a public process providing affected parties an opportunity to give input into the rule-making process. It also, of course, lends credence to our suggestion below that the "official" regulatory process is using the audit profession to do its rule-making work by the back door. We also cannot exclude the possibility of other private advice and discussion. But from the key public viewpoint major concerns arise from a regulatory due process perspective.

4.2 *An auditor over-ride?*

We have provided specific illustration of the specification of a company's detailed accounting policies by its auditor, when existing GAAP within the hierarchy is inapplicable or incomplete. But this leads to the logically prior question: *who decides when an existing regulation is inapplicable or incomplete?* The day-to-day practical answer to that question is either the preparer or the auditor (as is absolutely inevitable if the principle of substance over form in relation to the *individual* entity's "underlying economics" is to be applied). In its near-final SFAS on The Hierarchy of Generally Accepted Accounting Principles the FASB makes clear that it should be the enterprise (not the auditor) that is responsible for selecting accounting principles (FASB, 2006). Section 3 on the other hand provides examples in the US context where the auditor assumes authority over the preparer and imposes its own "branded" policy on its clients.

Putting these two points together, the auditor both a) decides whether existing GAAP rules apply, and b) imposes its own rules if they do not. The auditor (with of course the necessity for a rational defence against *ex post* investigation by the SEC or PCAOB or some other comparable regulator) can therefore *over-ride* an existing regulation on the (subjective) grounds that it fails to show the economic substance of the situation. We do not necessarily imply that this is at all a bad thing. We do point out that it is against all the rhetoric of hierarchical due process, and also of "public" (i.e. political) control.

A particularly significant point to emerge from our presentation and discussion is surely the effect on the practical operation of GAAP hierarchies. We showed at the end of section 3 that the major regulatory parameters (rules?) relevant to deciding what a company has to do are low down the US GAAP hierarchy. Section 3 as a whole shows that as far as a particular company is concerned what it has to do is determined by sub rules, interpreting the GAAP rules, which may be imposed by its auditor (without due process and a clear mandate, see 4.1 above). Footnote 14 illustrates that the process gives priority to very detailed lower level GAAP rules, whether promulgated or not, even if a higher level regulation, e.g. full-blown Standard as in footnote 14, is being ignored in both spirit and letter. The official US GAAP hierarchy is being reversed in its practical application. Stronger points can be made, however. We have argued in footnote 14 that the rules regarding "vendor-specific fair value" from a SOP (category *(b)*) are explicitly inconsistent with SFAS 157 definitions (category *(a)*), and it is the SOP on which the audit firms base their detailed rules (which latter are either category *(d)* or even below). It is these detailed rules (category (d) or below) which determine the practical outcomes, and the numbers in the financial statements. Even more fundamentally[18], following from section 302 of the US Sarbanes-Oxley Act (Pub. L. No.107-204; 2002) and the SEC's rules (Release No. 33-8124, Certification of Disclosure in Companies' Quarterly and

[18] We are grateful to Lawrence Cunningham for comments on an earlier draft which have significantly clarified our ideas in this section. The attitudes and arguments expressed are the sole and complete responsibility of the authors.

Annual Reports, 29 August 2002), CEOs and CFOs are required to certify that the company's financial statements present fairly the financial condition and results of operations of the company. In the explanatory (narrative) portion of its release, the SEC refers to the need to reflect the "*underlying* transactions and events" (emphasis added).[19] Since the required treatment of ARSs and VRDNs which we demonstrate in section 3 absolutely clearly fails to do this, it is not only incompatible with higher level items in the GAAP hierarchy, one may argue that it is simply illegal under US law! But it is still being vigorously enforced. We conclude that auditor GAAP is shown to be a significant part of a practical reversal of the official US GAAP hierarchy. The *de facto* position is opposite to the *de jure*.

But we do not believe that this is the end of the story. The required certification described above makes no mention of GAAP. The certifying officer is required to certify (S.240.13(a) – 14(b)(3)) that

> Based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report.

Certification of, or comment on a failure to provide, consistency with GAAP is not required. This wording, closely following the phraseology in the Sarbanes-Oxley Act itself, surely represents a deliberate attempt by Congress to reduce the significance of GAAP, viewed as a set of rules, and to increase the significance of "presents fairly". The traditional wording of a U.S. audit opinion ("presents fairly in accordance with generally accepted accounting principles") has been carefully avoided.

This change may perhaps be viewed as no more than a belated recognition of the true legal position as determined by U.S. Courts. The leading case is the so-called Continental Vending case (United States v Simon, 1970). This case was held before a jury, and may be taken as legal precedent that twelve ordinary intelligent U.S. citizens, after hearing weeks of close legal and accounting argument about rules,

[19] This is consistent with Levitt (2003): "(n)ew rules should ensure that the underlying economics of any company are reflected in the balance sheet".

practices and GAAP, may have the simple common sense to get back to the key question (were the financial statements misleading?) and find accordingly.

The issue for the Court of Appeals in Simon was the correctness of the trial judge's instruction to the jury. The defendants wanted the instruction to say (in effect) "(1) we can be guilty only if, under GAAP, the financials did not fairly present etc and (2) then only if departures from GAAP were made wilfully and with intent to deceive". The trial judge refused to give these instructions, telling the jury instead that the issue was whether the financials were fairly presented. The jury having found that the financials were not fairly presented, the Court of Appeals only had before it the issue of whether the instruction was correct (and it held that it was correct). The Court of Appeal (composed of course of lawyers) seemed surprised itself, concluding its refusal to overturn the guilty verdict as follows:

> Finding that the evidence was sufficient for submission to the jury and that no legal errors were committed, we must let the verdict stand.

Perhaps only another jury can stop the FASB from supporting the prevalence of detailed lower-order rules over higher-level principles of economic substance!

To put the point more clearly, suppose that a set of financial statements follow "auditor GAAP", as the term is used in our paper, or, for that matter, "preparer GAAP", and that the GAAP used is inconsistent with the GAAP hierarchy as pronounced. If the relevant directors are accused of failing to prepare 'proper' financial statements, how will a court react? If the court follows the Continental Vending case, which we submit stands as a relevant case precedent, then it will likely decide the issue *purely on the question of whether or not the financial statements presented fairly*. If this analysis is correct, then the source of the detailed rules, and the actual content of the detailed rules, turn out to be irrelevant, except to the extent that a jury *chooses* to allow its interpretation of "fair presentation" to be influenced thereby.

Such a conclusion is seen to be consistent both with the decision in Continental Vending, and the wording of Sarbanes-Oxley. Such a result would permit the triumph of substance over form, and common sense, over the legalistic absurdities of the FASB and SEC, whether or not those absurdities were aided and abetted by “auditor GAAP”. We suggest however that, in our view unfortunately, preparers are unlikely to mount a legal challenge to the FASB/SEC/Auditor bureaucratic conspiracy, in which situation users will continue to receive useless, or even misleading, information (as illustrated in sections 3.1 and 3.2).

Some of the arguments in this section have already been pointed out by Ijiri (2005). He has noticed (p267) both the absence of any mention of GAAP in the Sarbanes-Oxley certification requirements, and the likely relevance of the Continental Vending case. But the conclusions that he draws are different. In the explicit context of Continental Vending, he states as follows.

> Up to that time, it was considered to be sufficient to follow GAAP fairness which is based on the profession’s standards. Now, *that is not enough*, and certification by CEO/CFO should be based on pure fairness (emphasis added).

Ijiri’s preference for what he explicitly accepts is a lower level of requirement is clearly stated in his Abstract (p255).

> The article concludes with the strong need to focus on “procedural fairness” in establishing accounting standards as well as in implementing the reform legislation and administration, in contrast to “pure fairness” that is almost impossible to achieve by anyone.

Our preference is different, as we prefer partial success in achieving the useful, rather than total success in achieving the useless.

4.3 *Implications for the IASB and the global harmonisation process*

We have provided evidence in section 3, within the US context, that in practice rules may extend to the level of minutiae, and may be auditor-imposed, outside any mandate and claimed due process. We see no logical reason why this phenomenon should be restricted to the US. IAS 8.12., similarly to the US GAAP hierarchy, also requires enterprises to look at “other accounting literature” and accepted industry practices when developing and applying an accounting policy for a transaction that is not specifically dealt with in a Standard or an Interpretation. Therefore, if the Schipper (2005: 122) prediction given in section 2 turns out to have validity (and noting firstly that the more principles-focussed IFRSs leave more scope for possible later rules creation than US GAAP does, and secondly that the audit firms enforcing their own interpretations of IFRSs are likely to be the same organisation, with the same in-house technical department, as is now creating the rules in the US context), then a widespread application of the phenomenon seems extremely likely.

KPMG's "practical guide to IFRSs" (KPMG, 2006: 684/5) addresses software revenue recognition, using an example, as follows.

> IFRSs do not provide specific guidance on revenue recognition for software-related transactions. Often, software sales arrangements provide for sale of the software, together with subsequent servicing or licence arrangements. The substance of the transaction should be considered to determine whether the various components are linked and therefore accounted for as a single contract. The general revenue recognition rules are applied to each component.
>
> For example, K develops anti-virus software and sells non-renewable licences for the use of the software. The licencee receives the following during the licence period (which generally is two years):
>
> - use of the software over the period of the licence;
> - technical support in case of problems in installing and running the software; and
> - an unlimited quantity of updates of the virus database, but not to the software itself.
>
> The various elements of the product (as above) are not sold separately. Once the licence period ends, users who want to continue using the software are required to pay the full fee again.
>
> *In our view*, the components of the licence fee are not separately identifiable because no identifiable selling price exists for each of the components and each component of the product is considered to be directly interrelated to the others. The software on its own would be useless without the regular virus upgrades. We believe that the whole fee should be recognised as revenue over the licence period on a straight-line basis, unless there is another more appropriate method.

> *In our view*, the stage of completion method is not always appropriate for the recognition of revenue for software licences and sales if the sale cannot be separated from any installation or services sold. In many cases the costs to complete the transaction and the direct costs incurred can be measured reliably. However, one of the costs incurred by the entity is that related to the cost of initial development of the software package. This cost would be related to all software and licences sold by the entity and not only to a single package sold to a single customer. (emphases added)

Note in particular the double use of the words "in our view". Auditor determination of micro-rules does indeed seem set to spread and continue in the IASB context implying the same concerns as those raised for the US context. Even though IAS 1.13 demands financial statements to provide a fair presentation and even requires management to depart from a requirement in an IFRS it would result in misleading financial statements (if this is not in contradiction with the relevant regulatory framework) the apprehension remains that preparers will usually follow the detailed rules provided by auditors. However, in an international context with differing economic, political, cultural and legal environments the idea that detailed regulations will help to achieve the overall objective of a fair presentation of financial statements seems even more irrational than in a national context.[20]

[20] PricewaterhouseCoopers (2008) contains a foreword by Sir David Tweedie (page P007) which ends with the sentence "I recommend this Manual of Accounting, which gives preparers and practitioners the benefits of the extensive experience and professional judgement of PricewaterhouseCoopers". Whilst this statement is clearly an endorsement of the concept of auditor manuals, and "professional judgement" could be seen as a synonym for "auditor GAAP", it still gives explicit emphasis to "preparers and practitioners".

5) Conclusions and suggestions for further research

The genus of this paper was the availability of the extremely detailed evidence of micro rule making by auditors which we present in section 3. The general context is the broad macro issue of auditor GAAP. We have implicitly thrown out two major questions:

1. What is the appropriate balance of preparer and auditor involvement in the selection of detailed accounting policies? How acceptable is the situation we describe in section 3 and discuss in section 4?

2. We have provided evidence strengthening the proposition by Baker and Hayes (2004: 783) that the FASB is, directly or indirectly, actively supporting the superiority of form over substance in opposition to both public rhetoric and explicitly-stated regulatory philosophy. Is this to be tolerated?

The results of the recent moves in relation to cash equivalents under FAS 95 represent a triumph of form-based rules as against principle-based substance, and completely fail to give a fair presentation of the economics of the situation as they would be perceived from an investor perspective. We submit that answers to our questions above which would fail to rectify this situation are automatically inadequate.

The implications of the software revenue recognition problem seem less clear. The illustration given in section 3.2 surely demonstrates an absurd position in that the different and arbitrary numerical "bright lines" produce major differences of presentation of situations which have no major differences economically. But two ways can be suggested for avoiding this, from opposite philosophical perspectives. These are a) abolish "bright lines" altogether and stick to principles (as the KPMG IFRS Guide we quote in section 4.3 seems to do), or b) impose a single arbitrary "bright line". Our preference is for a), for reasons which two of the authors, together and otherwise, have discussed at length elsewhere (e.g. reference suppressed, 2007, with further references). But this juxtaposition only emphasises the importance of achieving broad agreement on the general issues underlying our questions above.

Several suggestions arise for possible further research. One question would be the precise motivation for the regulatory developments. Why, for example, did PWC issue their 2005 statement in the first place (and why in 2005?)? A different type of development would be to explore whether regulatory changes had any effect on client company actions. For example do companies generally change their liquid asset/short term investment operations as a result of the changes in reporting treatment?[21] Thirdly, and importantly, consideration of the implications of the auditor attitudes and actions discussed in this paper for other standards/regulatory systems (especially, but not only, IFRS), is called for. Finally whether there is a correlation between the auditors' tendency to issue auditor GAAP and the regulatory environment, particularly the auditor liability, would be worth exploring.

Lastly, what of the auditor as regulator? The involvement of the auditor in the interpretation and application of regulations prepared by others is inevitable. In a sense, that is their very reason for existence. But the illustrations given here suggest that auditors may use this position to impose precise, arguably misleading, and, we have argued, logically illegal, requirements on preparers that may best serve auditors needs but not those of other affected parties. The effect is to deny preparers, who alone have the legal duty to present proper financial statements, the right to consider "interpretation and application of regulations" for themselves. The responsibility of the management for selecting appropriate accounting principles is also stressed by the FASB in its reasoning for moving the GAAP hierarchy from the auditing literature to a SFAS.

The absence of a due process may lead to biased rules and it is no longer ensured that adequate consideration is given to the various views of the affected parties.

[21] SAP's 2007 financial statements show that SAP has sold all its investments in ARS and VRDNs in 2007.

Instead, accounting rules may be geared to best serve auditors' needs. Our concerns are that such "auditor GAAP" may stultify intelligent practice, and negate the possibility of giving a fair presentation of the underlying economic reality of particular transactions and events. The fact that, in the US, the FASB seems to be aiding and abetting such stultification and negation, by allowing or endorsing form over substance (in a way which perhaps allows preparers to blame auditors rather than the FASB itself) only makes our concerns all the greater. It seems that only an over-riding emphasis on the fair presentation requirement, undefined as it is, can rectify this situation. It also seems that such an emphasis, in the ultimate situation of a court case, is likely to exist.

Finally, we must point out that the situation we describe and demonstrate is set to be even more counter-productive if transferred to International Accounting Standards whether in a US context or globally.[22] The greater emphasis under IFRS on economic substance, on judgement, and on the general importance of the conceptual framework (unlike in the US GAAP hierarchy) renders the attitudes and actions we demonstrate here as absolutely unacceptable.

[22] Ernst & Young (2007b), in a report on the SEC roundtables of December 13 and 17, 2007, state that (p4)

> panellists indicated that in order for [IFRS] to be successfully implemented in the US, the US regulatory and legal environments would need to better support professional judgements made by companies and auditors.

Table 1 Proposed new US GAAP hierarchy

GAAP Hierarchy
Category *(a)*
• AICPA Accounting Research Bulletins (ARB) • Accounting Principles Board Opinions (APB) • FASB Statements of Financial Accounting Standards (FAS) • FASB Interpretations (FIN) • FASB Statement 133 Implementation Issues • FASB Staff Positions • For SEC registrants only: Rules and interpretive releases of the SEC
Category *(b)*
• FASB Technical Bulletins (FTB) • AICPA Industry Audit and Accounting Guides, if cleared by the FASB • AICPA Statements of Position (SOP), if cleared by the FASB
Category *(c)*
• AICPA AcSEC Practice Bulletins (PB) that have been cleared by the FASB • Consensus Positions of the Emerging Issues Task Force (EITF) • Topics discussed in Appendix D of EITF-Abstracts (EITF D Topics)
Category *(d)*
• Implementation guides (Q&As) published by the FASB staff • AICPA Accounting Interpretations (AIN) • AICPA Industry Audit and Accounting Guides and Statements of Positions not cleared by the FASB • Practices that are widely recognized and prevalent either generally or in the industry
Other Accounting Literature
• FASB Concepts Statements (CON) • AICPA Issues Papers • IFRS • Pronouncements of other professional associations or regulatory agencies • Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids • Accounting textbooks, handbooks and articles

Source: FASB (2006), "Near-Final" Statement of Financial Accounting Standards No. 1XX: The Hierarchy of Generally Accepted Accounting Principles, September 2006

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